TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING 96-25

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Application of the Sales and Use Tax Law, as amended by Chapter 739 of the Public Acts of 1996, to a road contractor who processes and fabricates the crushed stone and asphalt used in fulfilling public tax-funded road contracts.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

(A) The Taxpayer must not have misstated or omitted material facts involved in this transaction;
(B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
(C) The applicable law must not have been changed or amended;
(D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
(E) The Taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the Taxpayer's detriment.

FACTS

The Taxpayer is engaged in the business of quarrying, mining, fabricating and processing crushed stone and hot mix asphalt (collectively referred to herein as "the Products") for sale and transfer to third parties, or for use thereof in fulfilling its own highway installation and other paving contracts with public and private parties. Paving contracts entered into with public parties are all funded by tax dollars. Contracts entered into with private parties, such as subdivision roadways and parking lots, are privately funded.

The Taxpayer conducts its operations from a number of locations in Tennessee. At some of these locations, the Taxpayer sells fifty-one percent (51%) or more of its Products to third-party retail purchasers. At other locations, the taxpayer sells a smaller portion of its Products to third-party retail purchasers, and the balance thereof (other than that retained in stock-piled inventory) is used to fulfill its installation and paving contracts with public and private parties. The Taxpayer cannot predict with any degree of certainty what percentage of its Products, in any particular year and at any particular location, will be used to fulfill its obligations under public, tax-funded contracts as opposed to those obligations funded by private sources. It can, however, reliably predict that the allocation of the revenue produced and Products sold and/or used at each of its locations during each year may be categorized as follows:

1. At some locations, fifty-one percent (51%) or more of its Products are used to fulfill its own contracts for public, tax-funded projects, and fifty-one percent (51%) or more of its revenue at such locations is also from these contracts;

2. At other locations, fifty-one percent (51%) or more of its Products will be sold to third-party retail purchasers, and fifty-one (51%) or more of its revenue at such locations is also from these sales; or

3. At still other locations, the combination of its Products sold to third-party retail purchasers or used to fulfill its own contracts for public, tax-funded projects will constitute fifty-one percent (51%) or more of its Products at that location, and fifty-one percent (51%) or more of its revenue at such location.

At none of its locations will privately funded contracts account for a majority of its Products or revenue.

QUESTIONS

1. Is the taxpayer entitled to the industrial machinery exemption, the manufacturer's utilities exemption, and the industrial materials and explosives exemption at each location where fifty-one percent (51%) or more of its Products are used to fulfill its own contracts for public, tax-funded projects, and fifty-one percent (51%) or more of its revenue at such locations is also from these contracts?

2. Is the taxpayer entitled to the industrial machinery exemption, the manufacturer's utilities exemption, and the industrial materials and explosives exemption at each location where fifty-one percent (51%) or more of its Products will be sold to third-party retail purchasers, and fifty-one (51%) or more of its revenue at such locations is also from these sales?

3. Is the taxpayer entitled to the industrial machinery exemption, the manufacturer's utilities exemption, and the industrial materials and explosives exemption at each location where the combination of its Products sold or used to fulfill its own contracts for public, tax-funded projects will constitute fifty-one percent (51%) or more of its Products at that location, and fifty-one percent (51%) or more of its revenue at such location?

4. Assuming the taxpayer is entitled to the sales and use tax exemptions mentioned in Questions (1), (2), and (3), would any of these exemptions be pro-rated at any location if the taxpayer should use a portion of its Products (less than fifty percent (50%) at any such location) in fulfilling construction projects that are not publicly funded, but are privately funded contracts?

RULINGS

1. The taxpayer will qualify as a manufacturer and thereby meet the first test for the exemptions and reduced rates available to manufacturers under the facts applicable to Question (1); provided the public tax-funded projects are "highway or road construction projects ". The machinery, utilities, industrial material or explosives which may be subject to the exemption or reduced rate must also be *used* in a manner which will meet the requirements of the statute in order to qualify.

2. The taxpayer will qualify as a manufacturer and thereby meet the first test for the exemptions and reduced rates available to manufacturers under the facts applicable to Question (2). The machinery, utilities, industrial material or explosives which may be subject to the exemption or reduced rate must also be *used* in a manner which will meet the requirements of the statute in order to qualify.

3. The taxpayer will qualify as a manufacturer and thereby meet the first test for the exemptions and reduced rates available to manufacturers under the facts applicable to Question (3); provided the public tax-funded projects are "highway or road construction projects". The machinery, utilities, industrial material or explosives which may be subject to the exemption or reduced rate must also be *used* in a manner which will meet the requirements of the statute in order to qualify.

4. No. The exemptions are not prorated. However, in the case of utilities, separate metering will be necessary to obtain an exemption instead of a reduced rate.

ANALYSIS

The Rogers Case and Chapter 739

Chapter 739 of the Public Acts of 1996 (effective April 12,1996) was enacted in response to the decision in the case of *Rogers Group, Inc. v. Huddleston*, 900 S.W.2d. 34 (Tenn. Ct. App., 1995), *perm. to app. den.* The tax dispute in *Rogers* centered around the sales tax exemptions for manufacturers and the definition of industrial machinery contained in Tenn. Code Ann. § 67-6-102(12):

> Machinery, apparatus, and equipment with all associated parts, appurtenances, and accessories, including . . . repair parts and any necessary parts or taxable installation labor therefor, *which is necessary to and primarily for the fabrication or processing of tangible personal property for resale, and consumption off the premises* . . ., where the use of such machinery, equipment or facilities is by one who engages in such fabrication or processing as one's principal business . . . either within or without this state . . . . (Emphasis added).

A further definition found in Tenn. Code Ann. § 67-6-102(7) defined the critical language used in the definition of industrial machinery:

> "Fabricating or processing tangible personal property for resale" means only tangible personal property which is fabricated or processed for ultimate use or consumption off the premises of the one engaging in such fabricating or processing.

The Court concluded the definition of “fabricating or processing for resale” focused on the property’s use or consumption off the premises, and not on the sale of tangible personal property. The use of the tangible personal property in fulfilling these road contracts was considered to be identical to a sale. *Rogers*, 900 S.W. 2d. at 35.

Therefore, the manufacturer sales and use tax incentives were made available to a road contractor who was involved in the improvement of realty. This decision was contrary to the long standing interpretation of the Department of Revenue.

Recently, T.C.A. § 67-6-102(7) was amended to make it clear that the tangible personal property being fabricated or processed by the terms of the definition must be for *resale*; except in the case of hot mix asphalt and crushed stone fabricated by a contractor for use by the contractor in highway or road construction projects funded by tax revenues. As amended, the statute now reads as follows:

> "Fabricating or processing tangible personal property for resale" means only tangible personal property which is fabricated or processed for *resale and* ultimate use or consumption off the premises of the one engaging in such fabricating or processing, *or hot mix asphalt and crushed stone*

> *fabricated by a contractor for use by the contractor in highway or road construction projects funded by tax revenues;* (Emphasis on changes in text added).

1996 Tenn. Pub. Acts 739.

T.C.A. § 67-6-209(c) was also amended. It clarifies that the transfer of tangible personal property by a contractor (other than a contractor fabricating hot mix asphalt and crushed stone) who contracts for the installation of the tangible personal property as an improvement to realty does not constitute a sale of the tangible personal property by the contractor. The following new language was added to this statute:

> However, the transfer of tangible personal property by a contractor who contracts for the installation of such tangible personal property as an improvement to realty does not constitute a sale, except as provided in § 67-6-102(7), and the contractor shall not be permitted on this basis to obtain the benefit of any exemptions or reduced tax rates available to manufacturers under T.C.A. § 67-6-206 or § 67-6-102(23)(E). Each location of a taxpayer will be considered separately in determining whether the taxpayer qualifies or is disqualified as a manufacturer at that location."

1996 Tenn. Pub. Acts 739.

Generally, contractors under the current law may not obtain the benefit of the exemptions or reduced sales tax rates available to manufacturers as a result of the transfer of tangible personal property involved in fulfilling a contract to improve realty. However, contractors who fabricate the hot mix asphalt and crushed stone they use in highway or road construction projects funded by tax revenues qualify as manufacturers.

Farmers Co-op Case and the Fifty-One Percent Test

Tennessee Farmers' Co-op. v. State Ex Rel. Jackson, 736 S.W.2d 87 (Tenn. 1987) is the leading case on the fifty one per cent (51%) test referred to in *Rogers*. In this case, the Commissioner determined that Plaintiff manufactured or processed for resale less than 51 percent of the gross sales made at two separate locations and thus that Plaintiff's principal business did not constitute manufacturing within the meaning of T.C.A. § 67-6-206. The Court noted the Department of Revenue had used the 51 percent test on a location-by-location basis to determine the principal business of a taxpayer for many years. Under this test, to be considered a manufacturer for the purposes of T.C.A. § 67-6-206, the taxpayer is required to manufacture at least 51 percent of the gross sales made at each location. *Id*. at 88,89.

In considering the validity of this fifty one per cent (51%) test the Court said:

> The Commissioner has utilized the 51 percent test for at least twenty years and "[t]he Commissioner's interpretation is not 'palpably erroneous' and has been unchallenged for a substantial period. *See Gallagher v. Butler*, 214 Tenn. at 142, 378 S.W.2d at 166." *Neff v. Cherokee Insurance Co*., 704 S.W.2d 1, 6 (Tenn. 1986). While an administrative interpretation of a statute is not binding on a court, *Moto-Pep, Inc. v. McGoldrick, supra*, 202 Tenn. at 129, 303 S.W.2d at 330, the 51 percent test is consistent with the express statutory language of T.C.A. §§ 67-6-202 and 67-6-206. Tax statutes are construed *in pari materia. See, e.g., Art Pancake's United Rent-All v. Ferguson*, 601 S.W.2d 926, 930 (Tenn. App. 1979). We do not disagree with the Plaintiff that the Commissioner could devise another test than the 51 percent test to determine whether a taxpayer is a manufacturer within the meaning of T.C.A. § 67-6-206, but we cannot say that this test bears no rational relation to the statutory requirement; rather, the test is not only consistent with the intent of the statute but it also incorporates the basis on which the Retailers' Sales Tax is computed (i.e., gross sales).

Id. at 91,92.

Applying the 51 percent test used in the *Farmers Co-op* case means the gross sales from manufacturing must exceed other gross sales on a location-by-location basis. The gross sales test looks to the gross revenue produced from sales of the manufactured products. However, in the *Rogers* case, the fifty one per cent (51%) test was based on the amount of volume of goods or products processed instead of gross sales. *Rogers* at 35. In *Rogers* the court did not comment on this distinction from *Farmers Co-op*. Due to the unique nature of the taxpayer's contractor/fabricator business and its distinction from the retail sales business conducted in *Farmers Co-op*, it is arguable that a test based on the volume of material used may be more appropriate for road contractors.

However, based upon the facts presented with this ruling request, the taxpayer qualifies whether gross sales or the amount of the product are used in the test.

Application of Exemptions and Reduced Rates to the Taxpayer

Industrial materials and explosives are exempt if *used* by the taxpayer in the manner described in T.C.A. § 67-6-102(22)(E) :

> (i) Industrial materials and explosives for future processing, manufacture or conversion into articles of tangible personal property for resale *where such industrial materials and explosives become a component part of the finished product or are used directly in fabricating, dislodging, sizing, converting or processing such materials or parts thereof*; (Emphasis added).

The industrial machinery exemption is set out in T.C.A. § 67-6-206 for machinery described by T.C.A. § 67-6-102(12). The statute requires that the machinery be necessary to and primarily for the fabrication or processing of tangible personal property. Not all machinery used by a manufacturer qualifies for the exemption. The machinery must be used in the manufacturing process to qualify.

T.C.A. § 67-6-206(b) also provides either a reduced rate or an exemption from the sales tax for certain utilities and energy fuels used by manufacturers:

> (b) (1) Tax at the rate of one percent (1%) is likewise imposed with respect to water when sold to or used by manufacturers. Tax at the rate of one and one-half percent (1.5%) shall be imposed with respect to gas, electricity, fuel oil, coal and other energy fuels when sold to or used by manufacturers.
> (2) For the purpose of this subsection, "manufacturer" means one whose principal business is fabricating or processing tangible personal property for resale.
> (3) Such substances shall be exempt entirely from the taxes imposed by this chapter whenever it may be established to the satisfaction of the commissioner, by separate metering or otherwise, that they are exclusively used directly in the manufacturing process, coming into direct contact with the article being fabricated or processed by the manufacturer, and being expended in the course of such contact....

Principally engaging in manufacturing at a location will support the reduced state sales tax rates of one percent (1%) for water and one and one-half percent (1 1/2%) for energy fuels (including electricity). However, for energy fuels or water to be totally exempted from the state and local tax, it is necessary that the energy fuel or water come into direct contact with the product and be expended. The taxpayer must also keep accurate records to support the exemption. When electricity, energy fuels or water is metered, accurate meter readings showing the exempt portion and the total purchase are required. *See* Tenn. Comp. R. & Regs. 1320-5-1-.15(8).

Local sales tax does not apply if there is an exemption from the state tax. Electricity and most energy fuels are exempt from the local sales tax. T.C.A. § 67-6-704. The local sales tax rate on water is generally one half of one percent (.5%), but in some locations could be one third of one percent (1/3%). *See* T.C.A. § 67-6-702(b).

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